VZCZCXRO4388
PP RUEHCD RUEHGD RUEHHO RUEHMC RUEHNG RUEHNL RUEHRD RUEHRS RUEHTM
DE RUEHME #0240/01 0292020
ZNR UUUUU ZZH
P 292020Z JAN 08
FM AMEMBASSY MEXICO
TO RUEHC/SECSTATE WASHDC PRIORITY 0292
INFO RUEHXC/ALL US CONSULATES IN MEXICO COLLECTIVE
RHEHNSC/NSC WASHDC
RHMFIUU/CDR USSOUTHCOM MIAMI FL
RHMFIUU/CDR USNORTHCOM
RUEHC/DEPT OF LABOR WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RHMFIUU/DEPT OF ENERGY WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 03 MEXICO 000240

SIPDIS

SENSITIVE
SIPDIS

STATE FOR A/S SHANNON
STATE FOR WHA/MEX, WHA/EPSC, EB/IFD/OMA, AND DRL/AWH
STATE FOR EB/ESC MCMANUS AND IZZO
USDOC FOR 4320/ITA/MAC/WH/ONAFTA/GERI WORD
USDOC FOR ITS/TD/ENERGY DIVISION
TREASURY FOR IA (ALICE FAIBISHENKO, ANNA JEWEL)
TREASURY FOR IA (ALICE FAIBISHENKO)
DOE FOR INTL AFFAIRS KDEUTSCH, ALOCKWOOD, AND GWARD
NSC FOR RICHARD MILES, DAN FISK
EXIM FOR MICHELE WILKINS
STATE PASS TO USTR (EISSENSTAT/MELLE)
STATE PASS TO FEDERAL RESERVE (ANDREA RAFFO)

E.O. 12958: N/A
TAGS: ECON ELAB EFIN PINR PGOV MX
SUBJECT: FEAR OF U.S. RECESSION RATTLES MEXICAN MARKETS

REF: 07 MEXICO 2670

Summary

¶1. (SBU) The Mexican stock market is down 3.3% this month on fears that the U.S., Mexico's largest trading partner, could slip into recession. Real GDP growth currently is expected to slow this year to 1.5-3.0% from an estimated 3.1% in 2007 and 4.8% in 2006, due largely to the economy's tight links to the U.S. Fortunately, Mexico is better prepared to absorb economic shocks from the U.S. than it was in 2001. Domestic demand buoyed by more credit to the private sector, solid macroeconomic fundamentals, and increased government spending will help support local growth. The depth and duration of a recession in the U.S. as well as the Calderon administration's ability to continue passing much-needed structural reforms will be key factors in determining how the Mexican economy fares. End Summary.

Increased Volatility in Mexican Markets

¶2. (U) Mexico's IPC stock index plunged 5.3% on January 21 amid steep losses in European and Asian markets on U.S. recession fears. While the sell off was blunted by the U.S. Federal Reserve's decision to cut its benchmark rate 75 basis points to 3.5% on January 22, the market is still off 3.3% since the beginning of the month. The Fed's rate cut widened the spread with Mexico's 7.5% key rate by the most since January 2006 -- a move that has made Mexican yields more attractive. The yield on 10-year bonds due December 2016 has fallen 51 basis points to 7.67% so far this month. The peso fell 0.53% against the dollar on January 21, but has strengthened since then on bets the Fed will cut rates again this week and positive news on durable goods orders in the

U.S.

Concern Up, Growth Forecasts Down

¶3. (SBU) Econoffs have met with several government and private sector officials over the past week to get their perspective on recent market volatility and on how the Mexican economy would handle a recession in the U.S. These conversations show that while most officials remain cautiously optimistic about Mexico's growth prospects, concern has increased notably in recent weeks. Mexico's economy is simply too closely tied to that of the U.S. to escape unscathed. A senior Bank of Mexico (BOM) official told econoffs that the BOM planned to lower its real GDP growth forecast for 2008 to 2.75% - 3.25%; private sector forecasts range from 1.5% to 3.0%.

--- -
Better Positioned to Weather U.S. Recession...
--- -

¶4. (SBU) While acknowledging that slower growth in the U.S. would undoubtedly affect Mexico, Marco Oviedo Cruz, the Director of Financial Planning at the Finance Secretariat, told econoff that Mexico is better prepared to handle a U.S. recession than it was in 2001. He highlighted the country's solid macroeconomic fundamentals and noted how the manufacturing sector is more competitive than it was in the past. Echoing comments from private sector analysts, Oviedo commented on the importance of domestic demand as a driver of growth, noting that while credit to the private sector was

virtually non-existent seven years ago, it is now growing at high rates. The 2007 fiscal reform will also help propel the economy, as it will allow for higher levels of public investment in infrastructure and social programs. Oviedo remarked that while Mexico still sends most of its exports to the U.S., it has made progress diversifying the destination of its exports thanks to various trade agreements signed in recent years -- with Europe in particular. He added that productive sectors have been helped by the fact that the peso has been following the dollar -- which has been weakening.

¶5. (SBU) At a presentation in Monterrey on January 24, AmCham economist Deborah Riner echoed public comments by Finance Secretary Carstens that high oil prices also will allow the

SIPDIS
government to boost spending. She added that the informal economy will help buffer Mexico's fall since it is less dependent on the U.S. economy. Several analysts also have noted the importance of USG actions, such as interest rate cuts and the stimulus package.

¶6. (SBU) When asked how a significant slowdown in remittances would affect Mexico, Oviedo replied that the impact would be very limited since remittances represent such a small percentage of GDP. He noted, however, that poorer households that rely on the receipt of such transfers would take a hit. (Comment: Remittances help support many of the poorest families in Mexico. For them, remittance income is critical, if not for survival, at least for maintenance of their modest standard of living. End Comment.)

... But Fallout Inevitable

¶7. (SBU) While the variables listed above would help Mexico weather a U.S. recession, a series of other factors will curb Mexico's growth prospects:

-- Slower growth in the U.S. weakens demand for Mexican goods

in the U.S., the destination of more than 80% of Mexico's exports, according to Mexican trade statistics. Analysts note that Mexican exporters that depend on the U.S. for a significant portion of their revenues, such as Cemex and Vitro, have already taken a hit.

-- While Mexico's exports to the European Union have nearly doubled from 2000 to 2006 to USD 11.0 billion, a Director from the Graduate School of Business at ITESM (Monterrey Tec) noted that this figure is small compared to the amount of exports the U.S. buys from Mexico (USD 212 billion in 2006).

-- The head of Economic Research at Bank of America noted that Mexico is too dependent on the manufacturing sector in the U.S. to avoid a slowdown. The director from ITESM said the correlation between these two indicators was approximately 80%.

-- The Bank of America official and an economist from Consultores Economicos Espacializados in Monterrey tried to debunk the government's argument that countercyclical fiscal policy would help stimulate the economy. They said that the additional revenues available stem in part from the recent fiscal reform, adding that increasing taxes dampens rather than stimulates growth.

-- Several private sector officials also questioned how quickly the government could begin the infrastructure projects it is touting as a way to help absorb shocks from the U.S. The ITESM director said that while construction spending will help, states are not known to be efficient spenders of government funds.

Comment

¶8. (SBU) The GOM and private sector are closely watching how the crisis in the U.S. unfolds. If the U.S. slips into recession, the question is not if, but rather how much, Mexico will be affected. The answer to this question is largely tied to the depth and duration of the recession as well as which U.S. sectors are most affected. It is also linked to the Calderon administration's ability to continue passing much-needed economic reforms (energy, labor, competition, etc.) as mid-term congressional elections draw near. Such measures would not only improve Mexico's global competitiveness, they would also bolster investor confidence in Mexico's future.

¶9. (SBU) The effects of all this are not just economic. President Calderon and other political actors probably judge that lower growth and higher unemployment in Mexico can potentially influence the outcome of the July 2009 congressional elections. Moreover, the government would face significant pressure if Mexicans working in the U.S. return home because they cannot find work (e.g. if a Mexican employed in the suffering U.S. construction industry -- which 16% of workers of Mexican orgin do -- cannot find work elsewhere).

Visit Mexico City's Classified Web Site at http://www.state.sgov.gov/p/wha/mexicocity and the North American Partnership Blog at http://www.intelink.gov/communities/state/nap / GARZA